

Arvind TT, Gray Joanna.

[The limits of technocracy: Private law's future in the regulatory state.](#)

In: Kit Barker, Karen Fairweather, Ross Grantham, ed. *Private Law in the 21st Century*. Oxford: Hart Publishing, 2017, pp.237-255.

Copyright:

This is an Accepted Manuscript of a book chapter that has been published in its final definitive form by Hart Publishing on 26/01/2017

Link to publisher website:

<http://www.bloomsburyprofessional.com/uk/private-law-in-the-21st-century-9781509908585/>

Date deposited:

14/02/2017

The Limits of Technocracy: Private Law's Future in the Regulatory State

TT ARVIND
JOANNA GRAY

I. Private Law and the Regulatory Jurisdiction

Since the late Victorian period, private law has been faced with the challenge of coming to terms with the altered context created by the burgeoning administrative state. This challenge has two dimensions. The first, far from straightforward, arises from the need to take note of the existence of rules, regulations, and policies made by administrative agencies in deciding the scope of a party's rights and obligations. The courts are increasingly faced with actions arising out of heavily regulated relationships, in which their ability to deploy the traditional common law tests is necessarily coloured by the need to engage with the aims, goals, and policies underlying the relevant regulations, the majority of which are overtly systemic and consequentialist.¹ As one of us has discussed in detail elsewhere, the response of the courts to this challenge has been complex, and has taken obligations doctrine in a direction which calls into question many of the theoretical assumptions that are taken for granted in contemporary private law scholarship.² More serious, however, is the second dimension which arguably poses an existential challenge to private law, and is the primary subject of this chapter. For the transformation of the state in the course of this period has led to the creation of what is in effect a new jurisdiction – the regulatory jurisdiction – which actively intervenes in the very same relationships as private law, and which in intervening discharges the very same 'law-jobs'³ as private law once did: structuring relations, resolving conflicting expectations, setting standards of conduct, and prescribing remedies when those standards are transgressed.⁴ And, if one steps out of the world of private law theory to study the operation of the legal system as a whole, it becomes rapidly evident that the general trend has been one of the diminution of private law: of its withdrawal from these law jobs in favour of the regulatory jurisdiction.

Financial regulation provides a particularly clear example of this trend. In cases ranging from *Derry v Peek*⁵ to *Caparo v Dickman*⁶ and their counterparts elsewhere in the

¹ See generally WH Greenleaf, *The British Political System: The Rise of Collectivism* (London, Methuen, 1983).

² TT Arvind, 'Obligations, Governance and Society: Bringing the State Back in' in A Robertson and M Tilbury (eds), *The Common Law of Obligations: Divergence and Unity* (Oxford, Hart Publishing, 2016).

³ K Llewellyn, 'The Normative, the Legal, and the Law-Jobs: The Problem of Juristic Method' (1940) 49 *Yale Law Journal* 1355.

⁴ For a fuller account of this argument, see TT Arvind, *The Law of Obligations: A New Realist Approach* (Cambridge, Cambridge University Press, forthcoming 2017).

⁵ *Derry v Peek* (1888) LR 14 App Cas 337 (HL).

⁶ *Caparo Industries v Dickman* [1990] 2 AC 605 (HL).

common law world,⁷ the courts have refused to involve themselves in the task of setting standards of the type whose elaboration is fundamental to the success of financial markets. Equally, in virtually every case, the withdrawal of private law has led to an expansion of regulation. After *Caparo*, it is clear that auditors owe no common law duties to investors. This does not mean, however, that they are free to behave as recklessly as they choose. It means, rather, that the question of setting standards for the conduct of auditors has passed from the institutions of the common law to those of the regulatory state. And, in point of fact, regulators have intervened to formulate rules dealing with the precise problem at issue in *Caparo*, namely, that investors and capital markets suffer in consequence of the fact that auditors do not subject companies to sufficient scrutiny.⁸

The trend of the displacement of private law by the regulatory state has been discussed in detail elsewhere,⁹ and we do not propose to revisit it here. The question that this chapter explores is its implications for the future of private law. What role does private law have in a legal system increasingly dominated by regulatory institutions? Should private law respond in any way to its displacement by regulation? Does it have a wider role to play in common law legal systems, and if so what?

In recent years, corrective justice theory has sought to provide a powerful answer to these questions: one which calls for private law to put a *principled* distance between itself and the world of regulation, and to shape a role for itself based on fidelity to the idea of private law as a philosophically coherent normative phenomenon.¹⁰ The essence of this coherence, in turn, is said to lie in the normative link between the parties to a private law action and, in particular, in the mission of private law to ‘subject the interactions between one person and another to a system of coherent norms that is fair to both.’¹¹ On this account, the institutions of private law have their own ‘institutional character’ and ‘normative aspirations’¹² which differ sharply from those of the regulatory state. The problem, therefore, is not so much the displacement of private law by regulation, which may well be justifiable, as it is with private law taking on the colours of regulation by, for example, concerning itself with systemic issues, or conceding a central place to policy-based reasoning as it increasingly appears to be doing.¹³ Such matters should be left to regulators. Private law is better off concerning itself purely with issues of interpersonal justice, and with the relatively narrow and clearly-defined rights to which it has traditionally devoted itself.¹⁴

⁷ *Esanda Finance Corporation Ltd v Peat Marwick Hungerfords* (1997) 188 CLR 241, *Hercules Managements Ltd. v Ernst & Young* [1997] 2 SCR 165.

⁸ See eg Regulation (EU) No 537/2014 of the European Parliament and of the Council of 16 April 2014 on specific requirements regarding statutory audit of public-interest entities [2014] OJ L 158/77; and Directive 2014/56/EU of the European Parliament and of the Council of 16 April 2014 amending Directive 2006/43/EC on statutory audits of annual accounts and consolidated accounts [2014] OJ L158/196.

⁹ See eg M Lee, ‘Occupying the Field: Tort and Pre-emptive Statute’ in TT Arvind and J Steele (eds), *Tort Law and the Legislature* (Oxford, Hart Publishing, 2012).

¹⁰ In Weinrib’s famous phrase, “the purpose of private law is to be private law.” EJ Weinrib, *The Idea of Private Law* (Cambridge, Harvard University Press, 1995) 5.

¹¹ EJ Weinrib, *Corrective Justice* (Oxford, Oxford University Press, 2012) 7.

¹² *ibid.*, 8.

¹³ A Beever, ‘Policy in Private Law: An Admission of Failure’ (2006) 25 *University of Queensland Law Journal* 287.

¹⁴ See eg A Beever, *Rediscovering the Law of Negligence* (Oxford, Hart Publishing, 2007); A Beever, *The Law of Private Nuisance* (Oxford, Hart Publishing, 2013).

The difficulty with this argument is that, as recent developments have demonstrated, the regulatory state is as capable of providing interpersonal justice as are the institutions traditionally associated with private law. Financial misselling, utility overcharging, and a range of other civil wrongs are remedied by regulators not just with fines, but also orders to pay compensation and rules for the calculation of the quanta of compensation to be paid.¹⁵ If private law's role is solely to provide corrective justice, then it is only a matter of time before the regulatory state dispenses with the need for much of private law. The very same issue arises if we move from theories grounded in corrective justice to those grounded in consequentialist outcomes, such as the economic theory of law: there is no reason organs of the administrative state cannot be structured in a way that supports the achieving of outcomes which are economically efficient, or which minimise transaction costs.

A second possibility comes from trends within the judiciary itself, where there is a growing focus on the needs of complex, high-value litigation. Implicit in this approach is the view that courts have a particular skill at sorting through difficult facts, in situations characterised by an evidentiary trail that is both complex and voluminous. When they deal with facts, law, and contracts in a joined-up and binding manner, courts provide a vital service, for commerce needs a supervisory agency that works at the granular level of individual transaction, not just the system-as-aggregate. The courts, in this view, help to 'provide the necessary environment, identified by Adam Smith, for economic activity to thrive' by 'providing a mechanism for authoritative guidance'.¹⁶

Much of the change to the civil justice system in the common law world has been driven by the need to enable the courts to discharge this function efficiently. These include, at the institutional level, the growing importance of case management, at the doctrinal level, the steady replacement of socially-grounded tests such as the 'man on the Clapham omnibus' with approaches that are avowedly both pragmatic and technocratic, and at the procedural level the judicial push to create new forms of action to deal with emerging needs of high-level transactors within the commercial system, most recently in the financial list and the new financial test case procedure for very high value matters,¹⁷ which the English courts are in the process of implementing. The strength of this trend makes it easy to ignore the marginalisation of private law within the legal system, particularly given the historical position of commercial law and commercial lawyers within the discipline of private law. But while this idea of private law has a clear niche and future, it is one which many would regard as impoverished.

¹⁵ J Gray, 'The Legislative Basis of Systemic Review and Compensation for the Mis-Selling of Retail Financial Services and Products' (2004) 25 *Statute Law Review* 196. The regulator's use of this 'mass compensation' jurisdiction to effect industry-wide redress for mis-sold payment protection insurance policies was challenged unsuccessfully by the banking industry through judicial review in *R (on the application of the British Bankers Association) v Financial Services Authority and another* [2011] EWHC 999 (Admin). Financial regulators have also long been able to apply to Court for compensation by way of restitution orders in the event a regulated firm has contravened relevant regulatory requirements causing losses to a number of 'qualifying investors'. J Gray, 'Regulatory Restitution under Financial Services Legislation' (2004) 12 *Restitution Law Review* 52. For examples of the use of this type of jurisdiction, see eg *Securities and Investments Board v Pantell SA and others (No 2)* [1993] Ch 256.

¹⁶ Lord Thomas of Cwmgiedd, 'Speech at the Dinner for Her Majesty's Judges' (Mansion House, London, 8 July 2015), www.judiciary.gov.uk/wp-content/uploads/2014/07/lcj-speech-mansion-house-dinner-for-hm-judges.pdf, 4. The Financial List of the Commercial Court was established by the Civil Procedure (Amendment No. 4) Rules 2015, SI 2015/1569, and became operational on 1 October 2015.

¹⁷ *ibid.*

Is there, then, a case for a wider role for private law in the age of the regulatory state – one which extends beyond the narrow domain of providing a supportive environment for commercial and commercialised transactions? That is the question this chapter seeks to answer, by using the example of the regulation of the financial system. The central argument we seek to make by exploring this example is that a broader role for private law is not only possible, but arguably essential; and that this role lies not at the margins of the regulatory state but in domains that are at the heart of the modern system of regulation. Part II of this chapter begins by putting private law in the context of the regulatory state, and examining its role with reference not to doctrine and its methods but to regulatory theory. We take this approach not because doctrine does not matter, but because the regulatory state is here to stay, and any argument that seeks to articulate a case for taking private law's role seriously will need to be put in terms that address the claims of the other side, namely, the regulatory state. And, as this chapter will demonstrate, when we do this, we discover that private law is intelligible and important not only as a *doctrinal* institution but also as a *political* institution, part of the structures through which a polity is governed.

Part III puts this discussion in the context of financial markets, and argues that private law has a fundamental role to play in structuring and maintaining the institutional conditions for the existence of financial markets, in relation to which regulation cannot be a substitute. Part IV argues, however, that several features of modern private law, including core aspects of 20th century private law doctrine as well as the structure and priorities of the modern court system, place considerable hurdles in the way of actually achieving this contribution. Altering this position will require a fundamental shift in how we approach private law. Specifically, it will require us to move away from the traditional methodology of legal theory, of working 'backward from the doctrines and institutions of private law to the most pervasive abstractions in it,'¹⁸ to a new approach that takes as its starting point the positive role that private law can play in the modern state, and which places that role at the heart of the process by which private law doctrines, rules, and processes are elaborated, extended and developed; and which is far more sensitive to the social and transactional contexts in which private law operates than legal scholarship or legal doctrine has traditionally been.

II. Technocracy and Private Law: Differentiating Two Models

It is useful to begin by briefly sketching the main characteristics of the differences between private law and public regulation. The core of regulation lies in the notion of technocracy. It is important at this stage to clearly distinguish technocracy from the phenomenon expert decision-making. Expert decision-making involves the making of judgments on the basis of individual expertise. Technocratic decision-making, in contrast, entails the making of decisions according to technical criteria. It is technocracy in this latter, more specialised, sense that lies at the heart of the modern regulatory state. In historical terms, this form of dispute resolution is a relative newcomer to the common law world. Its roots lie in the middle of the 19th century, with the slow expansion of the functions of administrative bodies into areas that we would today recognise as regulation, although they would not have been seen in those terms in their contemporary setting. The Alkali Acts Administration, which was one of the earliest examples of technocratic regulation, serve both as an excellent example of the thinking

¹⁸ Weinrib (n 11) 26.

underlying technocratic regulation, and of the limitations of private law which made its rise necessary. The specific problem that prompted the creation of the Alkali Acts Administration was the problem of muratic acid gas, a by-product of alkali works which had a devastating impact on vegetation (and, hence, on farming). Although there was, in theory, a common law remedy in the form of the tort of nuisance, it did not, in practice, give much recourse:

partly in consequence of the expence such actions occasion, partly from the fact that where several works are in immediate juxta position, the difficulty of tracing the damage to any one, or of apportioning it among several, is so great as to be all but insuperable; and, that even when verdicts have been obtained, and compensation, however inadequate, awarded, a discontinuance of the nuisance has not in most cases been the result.¹⁹

Contemporary testimony from individuals affected by the discharge of noxious vapours suggests that these issues were real: the costs of an action of nuisance often took up over half the sums actually recovered by way of compensation,²⁰ and the compensation awarded fell far short of the loss actually suffered.²¹ This posed a genuine deterrent to litigation. Small proprietors adversely affected by noxious vapours ‘had not the courage to run the risk of an expenditure of 400 l or 500 l to recover perhaps 50 l’ even though they frequently had ‘suffered most grievously’.²² Where more than one factory was in the vicinity, the difficulty of proving causation led to actions not being commenced even when the damage was great.²³ In contrast, the Alkali Acts Administration, which was headed by Robert Angus Smith, a celebrated sanitary chemist, successfully dealt with the problem by setting precise limits on emissions, initially set in terms of percentages and, when those proved inadequate, in terms of volumetric standards of grains per cubic foot.²⁴ Equally, the fact that it was run by a respected scientist, and claimed its authority through the expertise of its personnel (many of whom had experience in the regulated industry), meant that it could engage with factories in a ‘co-operative and friendly spirit’, where it saw its role as being more ‘to assist the management in overcoming the difficulties’ that frequently arose with new processes, and ‘securing the best possible conditions from the points of view both of the public and of the industry itself’.²⁵

The chief attraction of technocracy, therefore, lies in its ability to claim objective *legitimacy* for the evaluative positions it adopts, to justify those positions with respect to the *expertise* of its members and the *suitability* of the technical criteria on which the positions in question are based, and to draw on that combination of legitimacy and expertise to induce a culture of compliance in the persons subject to regulation through *persuasion* as much as

¹⁹ *Report from the Select Committee of the House of Lords on Injury from Noxious Vapours* (London, House of Commons, 1862) v.

²⁰ *Minutes of Evidence Taken Before the Select Committee on Injury from Noxious Vapours* (London, House of Commons, 1862) 7.

²¹ *ibid* 8.

²² *ibid* 8-9.

²³ *ibid* 17.

²⁴ See generally R MacLeod, ‘The Alkali Acts Administration, 1863-84: The Emergence of the Civil Scientist’ (1965) 9 *Victorian Studies* 85.

²⁵ WA Damon, ‘The Alkali Act: Its Administration and Relation to Chemical Industry’ (1935) 54 *Journal of the Society of Chemical Industry* 1070, 1071.

through coercive enforcement.²⁶ The existence of these advantages does not, however, necessarily mean that regulation should, or necessarily must, displace private law. From the perspective of regulatory theory, private law, too, enjoys a distinctiveness that gives it an important role to play within the institutions of governance in any given jurisdiction. This distinctiveness lies not in the doctrines and remedies that are characteristic of private law, nor does it lie in the goals which the rules and structures of private law are said to pursue. It lies, rather, in the structure of its institutions and process – specifically, the role of adjudication and of the individual case in the process not only by which particular disputes are resolved, but also in the process by which private law evolves and its rules are made.

Two features of private law, in particular, acquire importance when we look at it through the lens of regulatory theory. The first is its ‘embedded autonomy’, a notion devised by Peter Evans, a scholar of public administration.²⁷ Embedded autonomy refers to the fact that the institution is embedded in society, and thus open to receiving and perceiving changing social expectations and legal needs, whilst at the same time also being sufficiently autonomous or independent from society to ensure that in the process of adapting to changing expectations and needs, it is not simply buffeted this way or that by the prevailing winds in society. The second feature is what has been called its inner normativity, which offers a classic example of what John Braithwaite, a regulatory theorist, has termed the ability of regulatory institutions to change cultures of vice to cultures of virtue by confronting sector participants with their ethical side.²⁸ Taken together, these lead to an approach to determining the boundaries of conduct which is rooted in socially-embedded understandings of responsible conduct, and which serves as an important complement to the risk-based approaches of regulators.

While the notion of inner normativity is familiar to theorists of private law, the idea of embedded autonomy is likely to be less so, and requires further elaboration. The importance of the notion of embeddedness to the common law can be seen if we begin with the classic work of Nonet and Selznick on the transformation of the common law in the course of the twentieth century. Nonet and Selznick describe the direction of legal development over this time as entailing a move from ‘autonomous law’ to ‘responsive law’²⁹ – or, to put it differently, from a law grounded in a model of rules applied and extended through artificial reason³⁰ to one more overtly concerned with and aware of its role as a ‘facilitator of response to social needs and aspirations.’³¹

The move, as they describe it, arises as a consequence of the limitations of autonomous law, for whilst autonomous law carries a powerful claim to legitimacy, it suffers from a serious drawback:

A focus on rules helps enforce a measure of official accountability; at the same time, it limits both the creativity of legal institutions and the risk of their intrusion into the

²⁶ See eg J Braithwaite, *To Punish or Persuade: Enforcement of Coal Mine Safety* (Albany, SUNY Press, 1985).

²⁷ P Evans, *Embedded Autonomy: States and Industrial Transformation* (Princeton, Princeton University Press, 1995).

²⁸ V Braithwaite and J Braithwaite, ‘Democratic Sentiment and Cyclical Markets in Vice’ (2006) 46 *British Journal of Criminology* 1110.

²⁹ P Nonet and P Selznick, *Law and Society in Transition: Towards Responsive Law* (New York, Harper & Row, 1978).

³⁰ *ibid* 62.

³¹ *ibid* 14-15.

political domain... Regularity and fairness, not substantive justice, are the first ends and the main competence of the legal order.³²

This leads to the displacement of autonomous law by newer systems of responsive law, grounded in a more instrumentalist jurisprudence, which favours openness to a wider range of factors over the preference for integrity that was immanent in autonomous law:

...good law should offer more than procedural justice. It should be competent as well as fair; it should help define the public interest and be committed to the achievement of substantive justice... Legal institutions were to... become more dynamic instruments of social ordering and social change.³³

At one level, this account appears to offer an accurate diagnosis of the factors underlying the growing shift from private law, characterised by an epistemically closed autonomy, to a more open and responsive system of regulation. Yet private law does not have to be, and is not in fact, so rigidly autonomous. The common law displays what is arguably the strongest *embedded* autonomy of any governing institution, through its ability to draw on a wide range of socially-informed experiential perspectives through its constant engagement with litigants, whilst at the same time retaining a degree of insulation from these perspectives through the necessity of filtering them through a layer of doctrine. Concepts in private law are not only expressed in a terminology that is socially embedded, using phrases such as ‘cause’ and ‘reasonableness’, but also derive their content from a broad range of cases involving a broad range of everyday situations. Private law doctrine is, in consequence, articulated in terms of concepts drawn from everyday experience, and developed through cases reflecting everyday situations.³⁴ This distinguishes it sharply from the structure and operation of the more technocratic institutions that are typical of the regulatory state which, as discussed above, are developed on the basis of engagement with technical models, rather than everyday situations, and are grounded in a conceptualism that reflects technical criteria, rather than experiential perspectives.

Taken together, the twin characteristics of inner normativity and embedded autonomy point to a significant strength of private law which set it apart from regulation and argue for giving it a continuing and prominent role even within the regulatory state – specifically, its potential to offer a way between the world of rigid determination according to clear rules (as is typical of purely administrative bodies), and of purely outcome-based determinations (as is typical of purely regulatory bodies), and in so doing to build on a far broader range of experiential perspectives, expectations, and socially embedded norms than one would expect to achieve through a more technocratically oriented regulatory process. As we will see in the next section, it is this strength, and the potential consequences of its marginalisation, that makes the future of private law a matter of profound importance.

³² *ibid* 54.

³³ *ibid* 73-74.

³⁴ This, arguably, is true of the common law generally and not just of private law. For a similar argument in relation to public law, see TT Arvind and L Stirton, ‘Legal Ideology, Legal Doctrine and the UK’s Top Judges’ [2016] *Public Law* (forthcoming).

III. The Limits of the Regulatory State: The Case of Financial Markets

Let us, then, return to the question with which this essay started. Given the relative strengths of private law and regulation, what role can or should private law play in the regulatory state? Do the strengths discussed in the previous section argue in favour of a broader role for private law than it currently plays? As this section will argue through an extended discussion of financial regulation, private law does have such a role, because the ability of financial regulation to deal technocratically with the problem of financial instability is inherently limited.

In the modern context, technocracy is frequently used as a term of opprobrium.³⁵ As the discussion in the previous section should have indicated, we do not use it in that sense in this paper. Technocratic regulation has made important contributions to modern governance which a system grounded in private law could not have made, in areas ranging from food safety to industrial pollution. Nevertheless, technocratic regulation has its limits. There is, in particular, a very significant difference between the technocratic regulation of *scientific* phenomena, that is to say phenomena such as the industrial pollution that was the subject of the Alkali Acts Administration, which are capable of being studied and evaluated through the natural sciences, and the technocratic regulation of *social* phenomena, which are not capable of being studied or evaluated through the natural sciences.

An important difference between the two are that the concepts and ideas implicated in the regulation of natural phenomena are criterial and capable of objective determination. There is an objectively correct answer to the question ‘how much sulphur does the vapour emitted by this plant have per cubic foot’, because there is an objective definition of ‘sulphur’ and ‘cubic foot’. This makes such phenomena particularly suited to being governed by regulatory systems which operate on the basis of technical criteria. The concepts implicated in social phenomena, in contrast, are typically interpretive and incapable of objective determination. There is no objective answer to the question ‘What is the net value of the financial assets held by a particular company’, because both ‘financial assets’ and ‘held by’ are capable of varying interpretations none of which can be said to be the objectively correct one, as evidenced not least by the significant differences one sees in the Generally Accepted Accounting Practices of different jurisdictions on this very point.³⁶ This subjectivity means that governance by technical criteria has limits in relation to social phenomena, including those that are the subject of financial regulation, which it does not have in relation to scientific phenomena.³⁷

This subjectivity was at the heart of the failure of regulation in the post-2008 financial crisis and, as we will see in the remainder of this section, it is this subjectivity that makes private law’s displacement by regulation a matter of particular concern. Financial regulation is purely regulatory in its structure, functioning and in its conceptual framework. There is no

³⁵ See eg J Habermas, ‘Technology and Science as “Ideology”’ in *Toward a Rational Society: Student Protest, Science and Politics* (JJ Shapiro tr, London, Heinemann, 1971).

³⁶ D Bholat et al, ‘Non-performing loans: regulatory and accounting treatments of assets’ (2016) Bank of England Staff Working Paper No. 594.

³⁷ Compare the point made by Ian Varcoe in relation to the growing gap in modern technocratic systems between ‘technical and social sophistication; between the level of technical control and that of understanding of, and ability to manipulate, the socio-technical environment.’ I Varcoe, ‘Technocracy and Democratic Politics’ in R Kilminster and I Varcoe (eds.), *Culture, Modernity and Revolution: Essays in Honour of Zygmunt Bauman* (London, Routledge, 1996) 67.

common law substrate to any of its components, unlike in many other forms of regulation, and it is becoming ever more so as its formulation is driven more and more by international and supranational standard-setting agendas. An important focus of the regulatory response to the post-2008 crisis, and more generally of regulatory policy direction in relation to finance, has been around the notion of ‘resilience’ and, in particular, the resilience of markets and institutions. Thus the Basel III Rules invoked the idea in their title: ‘A Global Regulatory Framework for More Resilient Banks and Banking Systems.’³⁸ The work of other regulatory actors is similarly organised, with the Financial Stability Board speaking of its mission in terms of ‘enhancing market and institutional resilience.’³⁹

Such a focus on resilience is not peculiar to the world of finance, but is typical of technocratic regulation. Resilience, as conceived in such models, has two facets. The first is the ability of a system to respond to disturbance or disruption by reorganising, adapting and changing to cope with the effects of that disturbance, while retaining its identity, structure and function.⁴⁰ The second is its ability to return to a state close to a previous equilibrium after this disturbance or disruption – an inherent robustness when faced with unforeseen challenges.⁴¹ This idea is primarily economic and systemic: the focus is on the resilience of the system as a whole, and of systemically important actors whose resilience is important to the continued vitality of that system. Thus the Basel rules, for example, focus on the resilience of individual banks and the banking system, and treat these as interwoven, with more resilient banks contributing to a system that is, overall, more resilient.⁴²

The result is that the disruption as well as the restored equilibrium are understood in economic terms, typically with reference to aggregated indicators, traditionally macroeconomic but increasingly also incorporating elements of microeconomics.⁴³ So, too, are the aetiology of crises, and the broad shape of the prophylactic regulatory measures needed to deal with them which are directed towards strengthening the ability of the system to adapt to unforeseen and unforeseeable risks.⁴⁴ The quantification of risk, and the use of technical criteria to manage its impact on the system, are accordingly fundamental to the regulatory management of the financial system. Prior to the crisis, the authorities in the UK used what was termed the “Advanced, Risk-Responsive Operating Framework” (ARROW), a cutting-edge form of supervision based on a calculation of the overall risk posed by an individual institution, using an estimate of the probability and likely impact of its default. ARROW represented, in many ways, the pinnacle of the idea of technocratic regulation of risk. Its aim was to ensure that supervisory time was used most efficiently, by focusing it on individual institutions in proportion to the risk they posed. The FSA created a complex matrix of risk

³⁸ Basel Committee on Banking Supervision, *Basel III: A Global Regulatory Framework for More Resilient Banks and Banking Systems* (2011) www.bis.org/publ/bcbs189.htm

³⁹ Financial Stability Forum, *Report of the Financial Stability Forum on Enhancing Market and Institutional Resilience* (2008) www.financialstabilityboard.org/publications/r_0804.pdf

⁴⁰ BH Walker et al, ‘Resilience, adaptability and transformability in social-ecological systems’ (2004) 9 *Ecology and Society* art 5.

⁴¹ I Gunderson, ‘Ecological resilience – in theory and application’ (2000) 31 *Annual Review of Ecology and Systematics* 425.

⁴² Basel Committee (n. 38) 2.

⁴³ J Gray, ‘Towards a More Resilient Financial System’ (2013) 36 *Seattle University Law Review* 799.

⁴⁴ J Walker and M Cooper, ‘Genealogies of resilience: From systems ecology to the political economy of crisis adaptation’ (2011) 42 *Security Dialogue* 143; P O’Malley, ‘Resilient subjects: Uncertainty, warfare and liberalism’ (2010) 39 *Economy and Society* 488.

elements, which it used to generate probability assessments of market actors on a firm-by-firm bases.⁴⁵ This was accompanied by a system of ‘principles-based regulation’,⁴⁶ which sought to ensure that the regulatory system did not get fixated on rules, but instead focused on the outcomes that regulation was intended to achieve.⁴⁷ ARROW and principles-based regulation were embedded within a system of governance of the financial system shared between three bodies: the Financial Services Authority, the Bank of England and the Treasury, whose joint responsibility were, in a manner typical of technocracy, set out not in law but in a Memorandum of Understanding entered into in 1997 when the system was created.⁴⁸

When this entire system spectacularly failed in the 2008 crisis, officials pinned a large part of the blame on the processes through which these estimates were made, where they said more extreme stress testing should have been used. For all the recent frantic institutional reform after the crisis, however, the basic approach has not been fundamentally changed.⁴⁹ A more strongly precautionary element has been introduced into the system, and stress tests of key financial actors have been made more extreme.⁵⁰ There is greater focus on risks endogenous to the game, on ‘aggregate risks and vulnerabilities across the system’ and on ‘imbalances through the financial system’ that must be identified and addressed to ‘improve the resilience of the financial system.’⁵¹ A ‘judgement-based’ element has also been introduced, which requires the Prudential Regulatory Authority to judge whether financial firms are safe and sound.⁵² And the PRA has developed ‘Fundamental Rules’, which seek to set out broad standards of conduct for firms, requiring for example that a firm must conduct its business with integrity⁵³ and with due skill, care and diligence,⁵⁴ act in a prudent manner,⁵⁵ control its affairs responsibly and effectively,⁵⁶ and so on. But the approach to resilience remains grounded in managing risks by assessing them, assessing the banks’ systems for dealing with them, and if need be requiring banks to take further steps necessary to secure market integrity and efficiency. And when it comes to the underlying criteria and touchstones

⁴⁵ See generally J Gray and J Hamilton, *Implementing Financial Regulation: Theory and Practice* (Chichester, Wiley Finance, 2006) ch 2

⁴⁶ J Black, M Hopper and C Band, ‘Making a Success of Principles Based Regulation’ (2007) 1 *Law and Financial Markets Review* 191.

⁴⁷ As with other characteristics of financial regulation discussed in this chapter, this, too, is not peculiar to financial regulation, but characterises technocratic regulatory systems in other areas, including environmental regulation and product design. See A Ogus, *Regulation: Legal Form and Economic Theory* (Oxford, Clarendon, 1994) ch 8.

⁴⁸ On the system generally, see R Lastra, *Legal Foundations of International Monetary Stability* (Oxford, Oxford University Press, 2006).

⁴⁹ See J Gray, ‘Financial Regulation Before and After Northern Rock’ in J Gray and O Akseli (eds), *Financial Regulation in Crisis: The Role of Law and the Failure of Northern Rock* (Cheltenham, Edward Elgar, 2011).

⁵⁰ Bank of England, *Stress testing the UK banking system: key elements of the 2015 stress test* (2015) www.bankofengland.co.uk/financialstability/Documents/stresstesting/2015/keyelements.pdf

⁵¹ HM Treasury, *A new approach to financial regulation: judgment, focus and stability* (Cm 7874, 2010) para 2.24.

⁵² J Gray and P Metzger, ‘Defining and delivering judgement-based supervision: The interface with the legal System’ (2013) 14 *Journal of Banking Regulation* 228

⁵³ PRA Rulebook: Fundamental Rules Instrument 2014, PRA 2014/17, Annex B, rule 2.1.

⁵⁴ *ibid*, rule 2.2.

⁵⁵ *ibid*, rule 2.3.

⁵⁶ *ibid*, rule 2.6.

that are the operational heart of the PRA's supervision, such as capital buffers⁵⁷ and credit risk,⁵⁸ they continue to be defined in terms that overwhelmingly reflect technical criteria.

What, then, is missing in this system, and what can private law add to this mix? The combination of embedded autonomy and a conduct-based approach mean that private law is capable of doing three things that regulation is not. The first goes to the idea of regulatory failure and, in particular, regulatory failure that is the result of the limitations of risk as an idea. Technocratic regulation is based on the use of expertise to manage risks that threaten goals. Yet such an approach is inherently limited, because the actuarial accounts of risks and resilience that are the mainstay of financial regulation represent, in Herbert Simon's terminology, simplified models of reality created by 'administrative man', out of which all aspects of the factual context deemed less relevant have been eliminated.⁵⁹ The distinction is sometimes described as being between actuarially manageable risk and unpredictable, ungovernable uncertainty.⁶⁰ Unlike regulation, the traditional concern of the common law was with uncertainty, dealt with through broad standards of conduct. Private law did not operate on the basis of an assessment of what was necessary to attain systemic stability and resilience. No judge has the power of the governors of the Bank of England or the FCA's chairman, to remake the rulebook pursuing a better way to achieve certain ends. The common law operates, instead, incrementally, on the basis of context-specific decisions, drawing on socially derived understandings of what must be done to avoid harming another. Such a system is not inherently concerned with the actuarial and managerial considerations that are the base of regulation.

Secondly, the regulatory approach to resilience is notable in that it is focused on the needs and perspectives of technocratic experts and institutional market players, and is institutionally insulated from the needs and perspectives of end-users and of the broader polity. As such, it fails to capture important aspects of financial crises and, in particular, the socio-cultural dimensions of resilience. In socio-cultural terms, resilience is understood in a much broader sense as the capacity to preserve well-being in the face of disruptive adversity, with a focus on the ordinary individual actor (rather than the exceptional systemically important actor), and on the manner in which that actor's plans, actions and perspectives come to be influenced by the crisis.⁶¹ This is not captured by credit default spreads, capital adequacy ratios, and bank stress tests. Policies targeted at resilience which do not take these aspects of resilience seriously will leave significant effects unaddressed, as the experience of communities suffering the effects of deindustrialisation has shown.⁶² It should be obvious that here, again, a more socially embedded approach to determining duties and remedies has a significant role to play. On both these points, the decision of the Federal Court of Australia in

⁵⁷ PRA Rulebook CRR Firms: Capital Buffers Instrument 2014, PRA 2014/9.

⁵⁸ PRA Rulebook CRR Firms Instrument 2013, PRA 2013/36.

⁵⁹ HA Simon, *Administrative Behavior: A Study of Decision-Making Processes in Administrative Organisations* (3rd edn, London, Collier Macmillan, 1976) ch 5.

⁶⁰ On the relationship between resilience and the management of uncertainty, see M Welsh, 'Resilience and responsibility: governing uncertainty in a complex world' (2014) 180 *The Geographical Journal* 15.

⁶¹ A Zautra et al, 'Resilience: A new definition of health for people and communities' in JW Reich et al (eds), *Handbook of adult resilience* (New York, Guildford Press, 2010).

⁶² D MacKinnon and KD Derickson, 'From resilience to resourcefulness: A critique of resilience policy and activism' (2013) 32 *Progress in Human Geography* 253.

the *Bathurst* litigation,⁶³ discussed in more detail in the next section, stands out as an example of precisely why there is an important role which private law is well-suited to filling.

Thirdly, dealing with the systemic issues posed by financial misconduct requires a focus on conduct-based action and not merely risk-based action, because risk-based regulation is producing outcomes that are near absurd. Take, for example, the requirement of disclosure, whose impact has been the creation of an extraordinary culture of defensive reporting, with reports becoming so complex and so detailed that even experienced professional analysts struggle to make sense of them. Banks are under so much pressure to disclose risk factors that they produce reports in which virtually everything is treated as a risk factor - in reality, meaning that nothing is treated as a risk factor.⁶⁴ This points to the limits of managerialism as an ideology of governance, and gives context to the importance of a different approach, of converting cultures of vice into cultures of virtue (as Braithwaite put it).⁶⁵ As we have argued elsewhere, this was the understanding that was at the heart of responses to the Victorian banking crisis; and it is strikingly absent today.⁶⁶ The focus of modern regulation is on acting against individuals committing acts of vice, not on changing institutional culture. Unlike the tort of negligence, where common law normative standards of conduct operate alongside regulatory action such as suspending licenses, in the area of financial regulation we see only the latter. This is a deliberate choice. In a speech at Davos, Mark Carney, the Governor of the Bank of England, emphasised that the task of reforming behaviour and re-establishing the system's reputation for integrity was not something regulators could do.⁶⁷ This stands in stark contrast with the response to the banking crises of the mid-19th century, before the birth of financial regulation in the modern sense, where the focus of the legal response was precisely to use legal standards of legitimate behaviour to deal with conduct that posed a systemic threat.

IV. Reshaping Private Law: Towards a Standard of Enlightened Morality?

This chapter has argued that the displacement of private law by regulation is fundamentally misplaced. Using the example of financial regulation, we have sought to show that the core institutional characteristics of private law, when seen against the backdrop of the modern financial system, offer an important complement to the regulatory institutions that currently dominate the governance of the financial system. The fact that private law *can* play this role does not, however, mean that it necessarily *does* so. As we discuss in this section, the direction in which private law has developed in its recent history has made it far more difficult for it to play this role.

⁶³ *ABN AMRO Bank NV v Bathurst Regional Council* [2014] FCAFC 65, confirming *Bathurst Regional Council v Local Government Financial Services Pty Ltd (No 5)* [2012] FCA 1200.

⁶⁴ M Spick, 'Berichterstattung von Banken – die große Informationsflut' (2015) 4 *Konzept* 8, 8-9, www.dbresearch.de/PROD/DBR_INTERNET_DE-PROD/PROD0000000000356070.pdf.

⁶⁵ Braithwaite and Braithwaite (n. 28).

⁶⁶ TT Arvind, J Gray, and S Wilson, 'From The Mid-Nineteenth Century Bank Failures In The UK To The 21st Century Financial Policy Committee: Changing Views Of Responsibility For Systemic Stability' in M Hollow, F Akinbami, and R Michie (eds), *Complexity And Crisis In The Financial System: Critical Perspectives on American and British Banking* (Cheltenham, Edward Elgar, 2016).

⁶⁷ Bank of England, *Remarks given by Mark Carney, Governor of the Bank of England at the Davos CBI British Business Leaders Lunch, 24 January 2014*, www.bankofengland.co.uk/publications/Documents/speeches/2014/speech705.pdf.

One set of hurdles is institutional. Recent changes to the civil justice system have, unfortunately, taken it in the opposite direction from where it will need to go to if it is to play a broader role in relation to finance. The abolition of legal aid for ordinary civil claims in England and Wales, for example, places significant hurdles in the path of ordinary claimants who seek to bring actions against large financial institutions. But so, too, do the case management procedures which were brought in in a bid to streamline the judicial process, but which have had the unfortunate effect of complicating collective proceedings. The experience of the Royal Bank of Scotland rights issue action points to the difficulty the common law litigation process has in dealing with claims involving large numbers of claimants. The action was brought on behalf of various action groups, representing institutional and individual investors, against the RBS alleging breach of s. 90 of the Financial Services and Markets Act 2000, on the basis that the prospectus issued in connection with the RBS rights issue in 2008 contained material misleading statements. The investors invested at 200p a share, only for the price to fall to 11p less than nine months later. Over 16,000 individual investors and over a hundred institutional investors are represented in the action. Proceedings were issued in April 2013. Three years later, the case remains in case management, with a tenth case management conference scheduled for June 2016, and the trial unlikely to start before March 2017. Over 25 million documents are involved, and RBS' defence costs alone are estimated at £90 million.⁶⁸

This problem is not unique to the common law, as the German experience with the Law on Model Proceedings in Capital Market Disputes (Kapitalanleger-Musterverfahrensgesetz, or "KapMuG") demonstrates. The KapMuG was passed in response to the difficulties created by one specific case, namely, an investor action against Deutsche Telekom. Deutsche Telekom issued an IPO in 1999. In 2001, following a revaluation of its property holdings, it wrote down the value of the land it held by around € 2 billion, causing its share value to plummet by 92%.⁶⁹ This resulted in over 16,000 individual lawsuits being brought against it in the courts at Frankfurt, all of which were, in theory, to be heard by a single judge. This posed significant logistical challenges for the court and, following the intervention of the Constitutional Court in 2004, the KapMuG was enacted in 2005.⁷⁰ Resolving the case took another seven years and a series of very complicated procedural steps.⁷¹ The ultimate result was that the action was dismissed in 2012 on the basis that the prospectus did not contain a misstatement. The case was then appealed on a point of law to the German Supreme Court, which ruled in 2014 that the prospectus did contain a misstatement, although one unconnected to the writedown of the real estate portfolio. The case then returned to the lower court to determine whether investors should be compensated for the fall in the share price.

⁶⁸ A brief history of the proceedings to date is available on the website of Leon Kaye, the solicitors for one of the groups of claimants: www.leonkaye.co.uk/class-actions/royal-bank-of-scotland-rights-issue-action-group/new/

⁶⁹ H Merkt, 'Managing Investor Mass Claims in Germany: Group Litigation under the new Investor-Sample-Proceeding-Law (KapMuG)' (2006) 17 *Journal of Interdisciplinary Economics* 117.

⁷⁰ Moritz Bälz and Felix Blobel, 'Collective Litigation German Style: The Act on Model Proceedings in Capital Market Disputes' in E Gottschalk, R Michaels, G Ruhl and J von Hein (eds), *Conflict of Law in a Globalized World* (Cambridge, Cambridge University Press, 2007).

⁷¹ For an overview, see AW Tilp and TA Roth, 'The German Capital Market Model Proceedings Act as Illustrated by the Example of the Frankfurt Deutsche Telekom Claims' in W van Boom and G Wagner (eds), *Mass Torts in Europe: Cases and Reflections* (Berlin, De Gruyter, 2014) 136-138.

As these examples suggest, both common law and civil law jurisdictions have struggled to provide an effective procedure for actions connected with capital markets. The procedures that do exist make actions time-consuming, protracted, procedurally complex, and extremely expensive. Yet the option of having recourse to private law remains popular: the KapMuG continues to be invoked in Germany, most recently in an action by investors in Volkswagen in connection with its admission that it had engaged in systematic manipulation of the results of emissions tests; and whilst there are few other cases akin to the RBS rights issue action in England, the relevance of private law actions is seen from their use by more sophisticated market transactors in England as well as other common law jurisdictions, most notably in the *Bathurst* litigation in Australia.⁷² This suggests that there is a need for private law to fill the gap left by the limitations of regulation, and that to the extent that its procedural limitations restrict its utility for retail investors, there is an urgent need to consider the question of how best to deal with these limitations.

By far a greater hurdle than the procedural one, however, arises from the current state of private law doctrine. As one of us has discussed in greater detail elsewhere, the withdrawal of private law from the task of setting standards has left it doctrinally crippled when it comes to coping with several features of modern transactions that are the mainstay of regulation: in particular, dealing with interaction involving Hohfeldian powers (rather than privileges), ruthlessly self-seeking action, and networks of connected transactions, all of which are typical of financial transactions (and, indeed, characterised the conduct of the defendants in *Bathurst*).⁷³ Part I of this chapter levelled an implicit criticism of *Derry v Peek*,⁷⁴ as typifying the courts' refusal to involve themselves in setting standards fundamental to financial markets. From this point of view, it is useful to contrast the law as it stands today with the law as it stood prior to the decision of the House of Lords in that case, not just with reference to the doctrinal position in the strict sense, but also with reference to the evaluative basis underpinning those positions. From this perspective, two points in particular stand out about the decision of the Court of Appeal in *Peek v Derry*⁷⁵ and the authorities on which it built. In doctrinal terms, of course, the clearest point of separation lies in the fourth limb of liability of fraud which the Court of Appeal articulated, namely, that a person would be liable in fraud if he made a statement which 'is untrue in fact but believed to be true, but without any reasonable grounds for such belief.'⁷⁶ The House of Lords, as is well known, rejected this in favour of the stricter test that continues to form the basis of the tort of deceit. Yet what is even more striking is the basis on which the judges of the Court of Appeal sought to justify the manner in which they applied this test. The defendants in *Derry v Peek* had argued that they had acted honestly and reasonably, because they had sincerely believed that the Board of Trade would consent to the use of steam power in running the line and had done no more than act on that belief. Stirling J in the High Court agreed:

Mercantile men dealing with matters of business would be the first to cry out if I extended the notion of deceit into what is honestly done in the belief that these things

⁷² *ABN AMRO Bank NV v Bathurst Regional Council* [2014] FCAFC 65.

⁷³ See Arvind (n 2).

⁷⁴ *Derry v Peek* (1888) LR 14 App Cas 337 (HL).

⁷⁵ *Peek v Derry* (1887) LR 37 Ch D 541.

⁷⁶ *ibid*, 585 (Lopes LJ).

would come about, and when they did not come about make them liable in an action of fraud.⁷⁷

The Court of Appeal did not agree. In his judgment, Sir James Hannen dealt directly with Stirling J's point:

It appears to me that nothing can morally justify a man in stating a thing as a fact, as existing at present, because he expects that it will exist in the future... I can only say that there are two classes of mercantile men. There are those who have lax notions of the duty of taking care to be accurate, and those who are scrupulously careful to observe this duty; and it is the opinion of the latter class to which I attach most importance.⁷⁸

It is striking that Sir James Hannen sought to ground his decision in commercial morality, and that he did so by invoking a certain understanding of morality that he located in the more 'scrupulously careful' class of transactors. Given the discussion in Part II, this has obvious significance. More importantly, though, it is difficult to imagine a modern court being willing to base its decision on a similar ground. In modern private law adjudication, it is common to read of the importance of commercial context,⁷⁹ or of market expectations,⁸⁰ but one seldom sees the upper judiciary invoking *normative* standards of commercial conduct based on the conduct of the more 'scrupulous' transactors in aid of a decision. To the contrary, to the extent there is a trend, it has tended in the opposite direction for, even when dealing with standards that on their face might appear to impute a socially embedded approach, such as the man on the Clapham omnibus, the tendency has been to emphasise the fact that these standards are legal standards, to be applied by the court on the basis of legal criteria rather than with reference to socially embedded norms.⁸¹

The decision of the Court of Appeal in *Peek v Derry*, however, was not exceptional in its day in its use of the idea of commercial morality (or 'enlightened morality', as Frederick Pollock termed it in his deeply critical comment on the decision of the House of Lords).⁸² As Pollock discussed, it was merely the latest in a long line of cases to base itself on the 'judgment of enlightened morality.' In *Adamson v Jarvis*,⁸³ Best CJ had put the principle even more broadly:

He who affirms either what he does not know to be true, or knows to be false, to another's prejudice and his own gain, is both in morality and law guilty of falsehood and must answer in damages.⁸⁴

Best CJ went on to draw a distinction between a case where a party gave his opinion because he was asked, despite having no interest in the matter. Here, an honest but mistaken answer

⁷⁷ *ibid*, 558 (Stirling J).

⁷⁸ *ibid*, 584 (Sir J Hannen).

⁷⁹ The interpretation of contracts being a particularly clear case in point: *Investors Compensation Scheme v West Bromwich Building Society* [1998] 1 WLR 896 (HL).

⁸⁰ See eg *Transfield Shipping Inc v Mercator Shipping Inc (The Achilles)* [2009] 1 AC 61 (HL) [23] (Lord Hoffmann).

⁸¹ *Healthcare at Home Ltd v The Common Services Agency* [2014] UKSC 49 [3] (Lord Reed).

⁸² F Pollock, '*Derry v Peek* in the House of Lords' (1889) 5 *LQR* 410, 412.

⁸³ *Adamson v Jarvis* (1827) 4 Bing 66.

⁸⁴ *ibid*, 73.

would be acceptable. But where there was an interest involved, the higher standard must apply. Pollock endorsed this view, and thought that the decision of the Court of Appeal in *Peek v Derry*, had it stood, would have been a step in extending the law in this direction, an extension he regarded as ‘legitimate and desirable’ and ‘quite in accordance with the lines of development which the common law has followed in regard to actions and undertakings affecting the safety of others in person or property.’⁸⁵

Pollock was convinced that the common law would eventually take this path, even if the decision in *Derry v Peek* proved to be a complicating factor in the process. With the benefit of hindsight, it is of course evident that the common law has not taken that path. Yet it is at least arguable that it ought to have. Commentators from outside the law, writing in the aftermath of the post-2008 financial crisis, have lamented both the ‘systematic chain of misrepresentation’ that characterises complex financial transactions, as well as the growing lack of the sense of responsibility that ought to be implicit in the fact that those working in the financial system are, fundamentally, dealing with the money of another.⁸⁶ Against this background, they have stressed the need for an internalisation of the principles of ethical financial conduct, akin to the manner in which most people avoid stealing or murdering.⁸⁷ This, arguably, was precisely the attitude that underlay the approach taken by the Court of Appeal in *Peek v Derry*, and by Best CJ in *Adamson v Jarvis*.⁸⁸ From a legal point of view, the desocialisation implicit in the shift away from this attitude has been exacerbated by other trends that have characterised the recent evolution of private law, and which arguably represent the legal acceptance of aspects of commercial *practice* even though, in the language of Pollock, they run counter to ‘enlightened morality’. Modern private law displays a strong trend towards what we might term bilateralisation and individuation, leading it to disaggregate individual transactions from the networks of which they naturally form part, viewing the rights and obligations of each party towards each other party as if they constituted an isolated relationship raising issues distinct from those raised by the other relationships within the network. It also displays a strong tendency towards contractualisation, seen not least in the reluctance to award compensation for pure economic loss in non-contractual contexts, and the surprising, and ongoing, expansion of assumption of responsibility beyond negligent misstatement into areas such as physical injury.⁸⁹

The impact of these trends has been particularly strong in relation to equity, reflecting a broader failure to recognise that equity is based on a more relational and social understanding of transactional relationships: one that recognises the embeddedness of market transactions in a social context, and one that therefore has the necessary conceptual framework that will be needed to deal with the issues and expectations raised by that social context.⁹⁰ In particular, equity has historically been particularly closely associated with situations where the questions concern the opportunistic exercise of powers, and thus import an element of dependence, and

⁸⁵ Pollock (n 82), 422-423.

⁸⁶ J Kay, *Other People's Money: Masters of the Universe or Servants of the People?* (London, Profile Books, 2015) 83-85, 282-284.

⁸⁷ *ibid.*, 272-273.

⁸⁸ (1827) 4 Bing 66.

⁸⁹ See, eg, *Ministry of Defence v Radclyffe* [2009] EWCA Civ 635; *Andrew Risk v Rose Bruford College* [2013] EWHC 3869 (QB).

⁹⁰ TT Arvind, ‘Contracts, Transactions, and Equity’ in LA DiMatteo, Q Zhou, S Saintier, and K Rowley (eds.), *Commercial Contract Law: Transatlantic Perspectives* (Cambridge, Cambridge University Press, 2013).

where these powers and dependence relate to control of assets and resources,⁹¹ precisely the sort of issues where most ground has been ceded to regulation in recent years. But it has equally influenced the operation of all private law duties that touch upon the financial system. Consider, by way of example, the decision of Lord Hoffmann in *Customs and Excise Commissioners v Barclays Bank plc*.⁹² Speaking of the basis on which the courts infer a duty of care in cases of pure economic loss, he discussed how duties might differ in different aspects of the same situation:

[I]n a case in which A provides information on behalf of B to C for the purpose of being relied upon by C, it is useful to ask whether A assumed responsibility to C for the information or was only discharging his duty to B... Or in a case in which A provided information to B for the purpose of enabling him to make one kind of decision, it may be useful to ask whether he assumed responsibility for its use for a different kind of decision... In these cases in which the loss has been caused by the claimant's reliance on information provided by the defendant, it is critical to decide whether the defendant (rather than someone else) assumed responsibility for the accuracy of the information to the claimant (rather than to someone else) or for its use by the claimant for one purpose (rather than another). The answer does not depend upon what the defendant intended but, as in the case of contractual liability, upon what would reasonably be inferred from his conduct against the background of all the circumstances of the case.⁹³

This is a long way removed from the approach taken by Frederick Pollock, Sir James Hannen, and Best CJ, which focused on the far simpler question of whether the person making the statement was acting for his own gain. The facts of the *Bathurst* litigation will help put these points in context. The case arose out of the creation of a complex, structured financial product by ABN AMRO which was, from the outset, intended to be specifically targeted at local councils in Australia. The product was known as a Constant Proportion Debt Obligation (CPDO) and was, in essence, a synthetic credit default swap (that is to say, a credit default swap which did not actually involve protecting against the risk of a credit default) linked to global indices which tracked pools of entities which in turn tracked a range of financial criteria.⁹⁴ Had this been a real CDS, the investors would have sold protection against default by the tracked entities to their counterparties. Because it was synthetic, the investors in effect entered into contracts with the counterparties which created obligations that mimicked the cash flows that would have taken place had the contracts been real CDSs. Although synthetic CDSs are common, and products similar to the CPDOs were not unknown, this precise product had never been seen before, and there were no precedents in relation to rating it.⁹⁵ ABN AMRO approached Standard and Poor, a leading credit rating agency, to give it a rating.

A rating of AAA was required if the CPDO was to be marketable to local authorities. Evidence adduced during the trial demonstrated how Standard and Poor (S&P) and ABN AMRO had adjusted the assumptions on which their models were based, including by adopting a volatility parameter they knew to be flawed, and by adopting other overly favourable

⁹¹ *ibid* 173-175.

⁹² [2006] UKHL 28, [2007] 1 AC 181.

⁹³ *ibid* [35].

⁹⁴ *ABN AMRO Bank NV v Bathurst Regional Council* [2014] FCAFC 65 [32]-[36].

⁹⁵ *ibid* [38].

assumptions, until they came up with an analysis that justified this rating. Several of S&P's analysts were dissatisfied with this process, and it was internally agreed that future instruments would be approached differently, but the formal letter with the AAA rating was issued notwithstanding these concerns.⁹⁶ This AAA rating was 'unreasonable, unjustified and misleading', as both ABN AMRO and S&P knew.⁹⁷ Both also knew that the primary purpose of securing an AAA rating was to induce investors to believe that the CPDO was a secure investment when, in fact, their own models did not justify asserting that it was that secure.

The notes were sold by ABN AMRO to an entity called Local Government Financial Services Pty Ltd (LGFS), which in turn sold it on to the councils. LGFS had little experience with structured financial products, and was unable to verify the rating.⁹⁸ Nevertheless, in its communications with the councils it made a decision 'only to show the key features which were positive, not those that presented risks',⁹⁹ so as to avoid hindering its ability to sell the notes on.¹⁰⁰ As it transpired, once the post-2008 financial crisis hit, the councils suffered very significant losses on their investment. The notes were redeemed at around 35% of their face value. S&P itself had by this time downgraded its rating to BBB+. The councils sued S&P, ABN AMRO, and LGFS.

The claim was allowed at first instance and upheld on appeal. All three defendants were held jointly and severally liable to the councils in negligence for negligent misstatement, in the statutory tort of misleading or deceptive conduct,¹⁰¹ as well as certain other causes of action. Three points about the court's finding on the negligence claim, in particular, stand out. Firstly, the court rejected the idea that the case involved novel circumstances. Because '[e]xpert information and advice is part and parcel of modern commercial life',¹⁰² the case was a straightforward one of applying the relevant test for the supply of negligent information and advice. On the facts, these were made out, because S&P as well as ABN AMRO must have realised that the councils and others receiving the information intended to act on it in connection with a serious matter, and because reliance was under the circumstances reasonable. Secondly, the court also rejected the idea that imposing a duty would on the facts lead to indeterminate liability, because on the facts the class of potential investors was both limited and ascertainable. S&P knew the size of the issue, and would therefore have been able to estimate a maximum number of investors with a relatively high degree of certainty. Thirdly, and relatedly, given that the class of investors was ascertainable, liability could arise even without the presence of a contract.

Yet, whilst this decision certainly reflects a welcome step forward, it remains inadequate at many levels. Because the decision is heavily fact-dependent, it leaves open questions about how wide its effect truly is. Would it apply if the ratings had been issued in circumstances that suggested an offer much wider than 80 – for example an offer to the general public? Would it apply had the products that were the subject matter of the rating been less complex – if, for example, the court did not have before it evidence comparable to that before

⁹⁶ *ibid* [145]-[373].

⁹⁷ *ibid* [563].

⁹⁸ *ibid* [75].

⁹⁹ *ibid* [128].

¹⁰⁰ *ibid* [130].

¹⁰¹ Under ss 1041E and 1041H, Corporations Act 2001, and s 12DA of the Australian Securities and Investments Commission Act 2001.

¹⁰² *ABN AMRO Bank NV v Bathurst Regional Council* [2014] FCAFC 65 [590].

the Federal Court, clearly demonstrating both the novelty of the CPDOs and the complete inability of the investors to ‘second guess’ the rating awarded by S&P? And, more fundamentally, does a case which leaves so much uncertain truly meet the objectives which private law is capable of meeting, and which underlie the case for its wider involvement in the legal system alongside regulation? These questions acquire particular importance in the light of the points discussed in Parts III and IV of this chapter, and in the light of the enduring relevance of the approach that underlay the 19th century jurisprudence discussed above. The disappearance of this broader understanding of the role of private law is then yet another symptom of the shrinking role that private law plays in the modern context, and part of the issues with which judges and jurists working in private law must deal, if private law, and the common law tradition it embodies, is to play anything more than a marginal role in the 21st century.